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Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

26 March 1984

Australia: The Winds of Financial Change [redacted] 25X1

Summary

The Hawke government's moves to float the Australian dollar and liberalize other foreign exchange regulations last December surprised financial analysts and underscored Canberra's desire to combat inflation by strengthening its control over the domestic money supply. Many observers consider the licensing of several foreign banks the obvious next step in financial deregulation. [redacted] 25X1

These policy departures pose problems for the Hawke government, however. The decision to float the dollar is further eroding Australia's international competitiveness and could antagonize Hawke's most important constituency--organized labor. In addition, we believe domestic politics will force Hawke and Treasurer Paul Keating to adopt a tougher line toward foreign banks than they would prefer. [redacted] 25X1

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This memorandum was prepared by [redacted] Islands Branch, Southeast Asia Division, Office of East Asian Analysis of the Directorate of Intelligence. Information available as of 7 March 1984 was used in its preparation. Comments are welcome and may be directed to the Chief, Southeast Asia Division, [redacted] 25X1

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Right on Course

Canberra's recent moves to open Australia's undeveloped financial system are consistent with the recommendations in 1981 of the Campbell Enquiry, a commission established by the conservative Fraser government in 1979. The commission was the brainchild of former Treasurer John Howard, now deputy leader of the opposition party, and its report strongly favored breaking down Australia's financial isolationism by opening the market to greater competition. Howard followed through on several of the commission's recommendations, including:

-- Removing controls on short-term capital inflows.

-- Permitting the development of merchant banking.

-- Liberalizing interest rate controls. 25X1

In our judgment, these policies produced an increasingly sophisticated domestic financial market which helped improve corporate financial management. The development of forward markets, cash management trusts, and a tender system for selling government bonds, for example, have all provided firms with greater flexibility in managing cash flows. Despite these gains, however, the Fraser government's growing political problems in late 1982 and stiff opposition from members of his own party forced Howard to abandon further reforms, including his long-time goal of floating the Australian dollar. 25X1

The Labor government's recent support of many of the Campbell commission's recommendations came as a surprise to most financial analysts. While in opposition the Labor Party had been critical of the Campbell report. Upon taking office in March 1983 the Labor government appointed a committee headed by Vic Martin--a leading businessman--to examine the potential social impact of the Campbell recommendations. It was widely believed that Labor would significantly tighten financial controls and regulations. Hawke, however, has abandoned ideology in favor of pragmatism, following economic policies often more conservative than those of the Fraser government. 25X1

The Decision to Float

Canberra's decision to allow the Australian dollar to float freely on foreign exchange markets resulted primarily from the government's concern over its growing difficulty in managing the domestic money supply, in our judgment. Beginning late last summer, expectations that the Australian dollar was undervalued attracted short-term capital inflows far in excess of those needed to cover the current account deficit (see Figure 1). As a result, the money supply and short-term interest rates fluctuated erratically, and money supply growth began to exceed the government's target rate of 9-11 percent (see Figure 2). Canberra tried to stem the inflow by slowly appreciating the

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dollar in an attempt to convince speculators that the exchange rate had peaked. By last October, the government had already appreciated the dollar by nearly 10 percent--effectively eroding any competitive advantage gained in the March 1983 devaluation. [redacted] 25X1

Canberra's strategy backfired in early December when speculators began anticipating further appreciations. Expecting an imminent revaluation, a total of $1.4 billion flowed into Australia in 10 days, forcing the government to suspend temporarily foreign exchange operations.* According to a variety of sources, Treasurer Paul Keating told the cabinet that the small appreciations were only reinforcing speculative behavior. With the support of Prime Minister Hawke, Keating convinced the cabinet that the only way to ease pressures on the money supply was to float the dollar. This decision, in our view, effectively put monetary policy back in the hands of the government, and ended the volatility of short-term interest rates. [redacted]

More Changes on the Agenda

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In addition to the float, Canberra is also liberalizing other foreign exchange regulations. Although nominal approval is still often required for data collection and tax purposes, the new policies:

-- Allow nonresidents to borrow capital in Australia--including issuing shares on Australian stock exchanges--and to operate in Australian future markets.

-- Permit Australian residents to hold foreign currency accounts in Australia, and borrow and lend offshore.

-- Permit Australian residents to invest overseas, either through direct or portfolio investment.

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-- Allow nonresidents to hold bank deposits and other interest-bearing investments in Australia. [redacted]

The Martin report, released late last month, urges the government to extend financial liberalization to the domestic market by removing interest rate ceilings on housing loans and on small overdraft accounts at commercial banks. One major recommendation would make commercial banks more competitive with merchant banks by gradually eliminating the restriction which bars commercial banks from paying interest on short-term deposits of more than $47,000. [redacted] 25X1

The Martin Comittee study, however, was less optimistic than

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*All figures are in US dollars. [redacted] 25X1

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previous reports about prospects for establishing offshore banking centers in Melbourne and Sydney. Following the relaxation of foreign exchange regulations last December, both cities began fashioning themselves as ideal locations for offshore banking. The Martin report, however, argues that the impact on employment and economic activity would be minimal. In any case, the development of offshore banking centers would require major tax concessions to the banking community to make the new centers competitive with existing offshore centers. Because the government is probably not willing to forgo tax revenues, it is unlikley that Sydney and Melbourne will develop into offshore centers capable of competing with Singapore and Hong Kong. Corporate tax rates in Australia are high compared to Singapore and Hong Kong, and Canberra imposes additional charges on financial transactions. [redacted] 25X1

Most of the financial community's interest in the Martin report centers on foreign bank entry--a move which most analysts consider the obvious next step in financial deregulation. The Martin Committee proposes that four to six new commercial banks be granted licenses, but also proposes strict conditions on foreign bank involvement. One of these requires at least 50 percent Australian equity, reflecting Canberra's policy toward other foreign investments. Initial reactions to this restriction from foreign bankers--including two US banks--have been sharply critical, and Martin himself is said to object. In addition, the report hints that any foreign banking licenses should reflect Australia's growing trade links with Asia, which could effectively shut out US and European banks from the market. [redacted] 25X1

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Potential Trouble Ahead

The Martin Committee's proposals on foreign banking reflect the political sensitivity of the issue in Australia. Both Hawke and Keating support foreign bank entry based on a belief that foreign banks have more experience in a wider range of services than do Australian banks. On the other hand, a large segment of the Labor Party and the party's binding policy platform now oppose the entry of foreign banks. The issue promises to be a heated one at the Labor Party's conference in July--Hawke's first opportunity to imprint his views on the platform.* [redacted] 25X1

Even the decision to float the dollar still has critics among government technocrats. The strongest opponent is the highly-respected Secretary of the Treasury John Stone. Stone, who in the same position also opposed floating the dollar during the Fraser government, argues that because of the small size of the Australian market the dollar will be vulnerable to relatively

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*According to US Embassy reporting, the government may decide to accept applications for licenses as early as April. [redacted]

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minor capital flows. This, he believes, will make the dollar volatile and raise uncertainty among exporters and importers. Evidence available since the float supports Stone's position, wide daily swings in the dollar's value have occurred since December. Against the Japanese yen, for example, the Australian dollar depreciated by 5 percent in only 11 days before appreciating by 7 percent over the next two months. 25X1

The general strength of the currency since the float is also causing concern among Australian exporters and import-competing industries. Since the float, the Australian dollar has appreciated by 4 percent against both the US dollar and the Japanese yen, making Australian goods more expensive abroad and foreign goods cheaper locally (see Figure 3). Together with an inflation rate that is more than double the OECD average, Australia's competitiveness--based on exchange rates adjusted for inflation differentials--has declined nearly 10 percent in the past ten months, and is now lower than at any time in the last five years (see Figure 4). Several unions and industry groups already have warned the government that a continuation of this trend will result in campaigns for additional protection from import competition. Neither Hawke nor the conservative-minded Keating would welcome moves to increase current levels of protectionism-- Australia already has one of the most protected markets in the OECD. 25X1

If, on the other hand, the dollar begins to depreciate, Hawke will face difficulties in his relationship with organized labor--his party's most important constituency. Australian officials recognize this and in talks with the IMF admitted that a depreciating currency coupled with full wage indexation would seriously complicate management of the economy. With an already tight monetary policy and record budget deficits, Hawke's only choices to break an inflation-depreciation link would be either to initiate another round of slow growth and high interest rates or to end wage indexation--a move which, we believe, would rekindle industrial unrest. 25X1

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Figure 1
Australia: Foreign Exchange Reserves

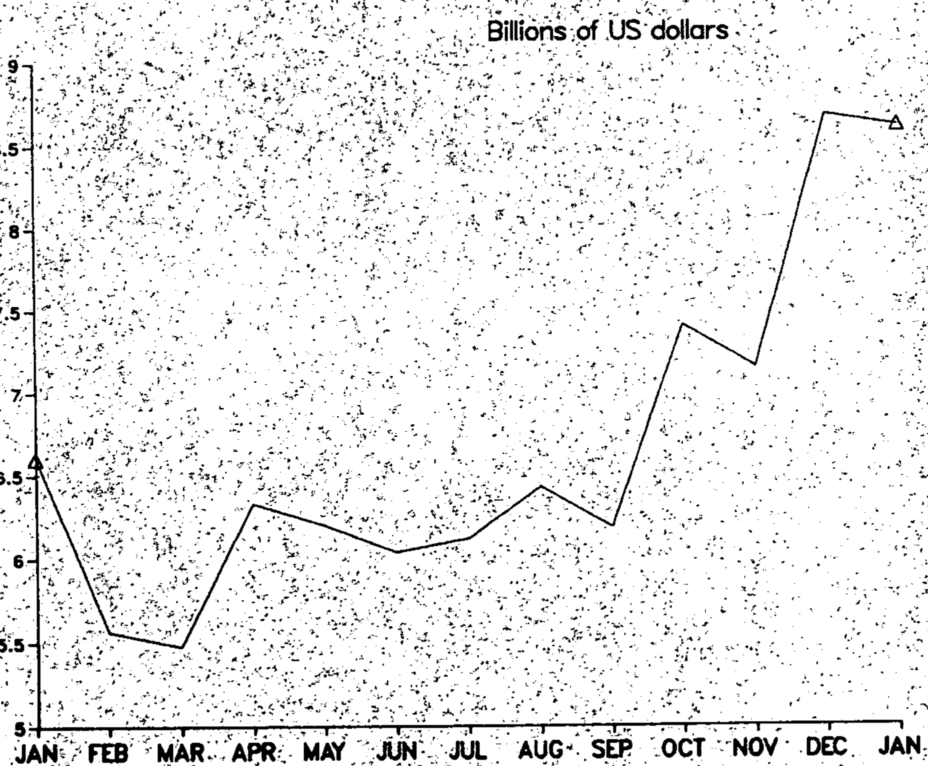

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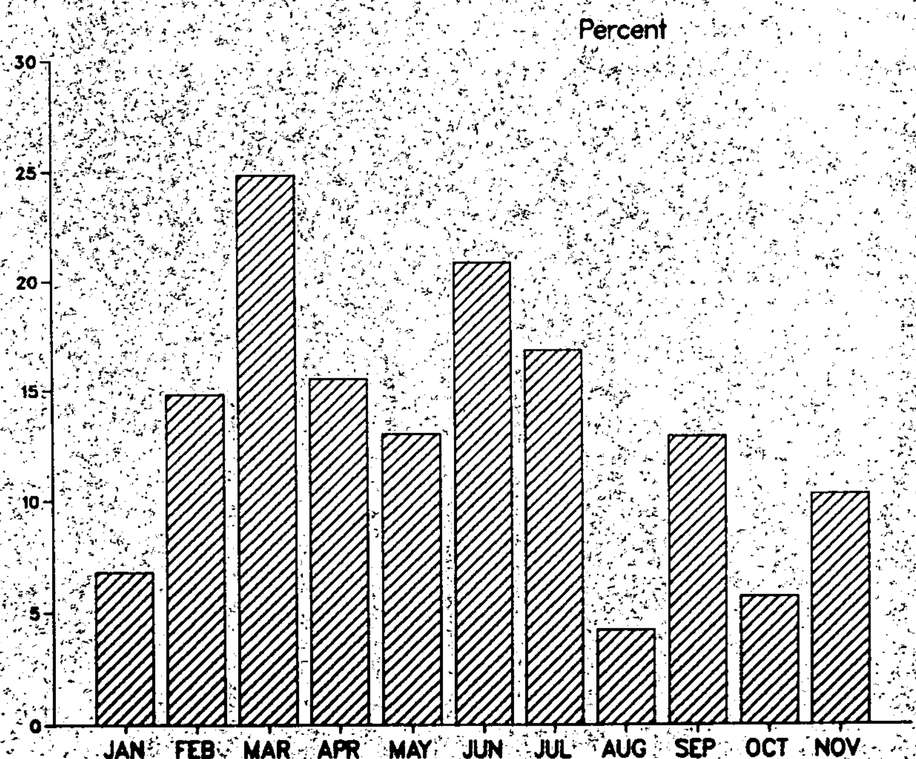
Figure 2
Australia: Money Supply Growth (1)



(1) Month to month changes in seasonally adjusted money supply at an annual rate.

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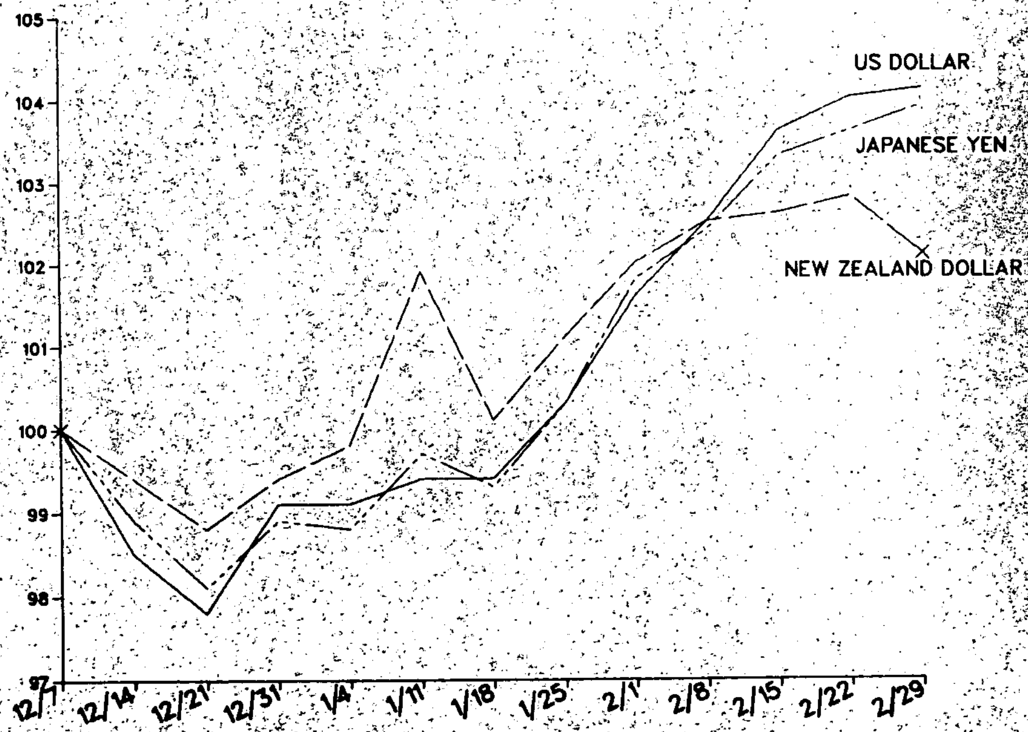
Figure 3
Australia: Exchange Rate Behavior Since the Float (*)

7 Dec. 1983 = 100



* Foreign currency units per Australian dollar.

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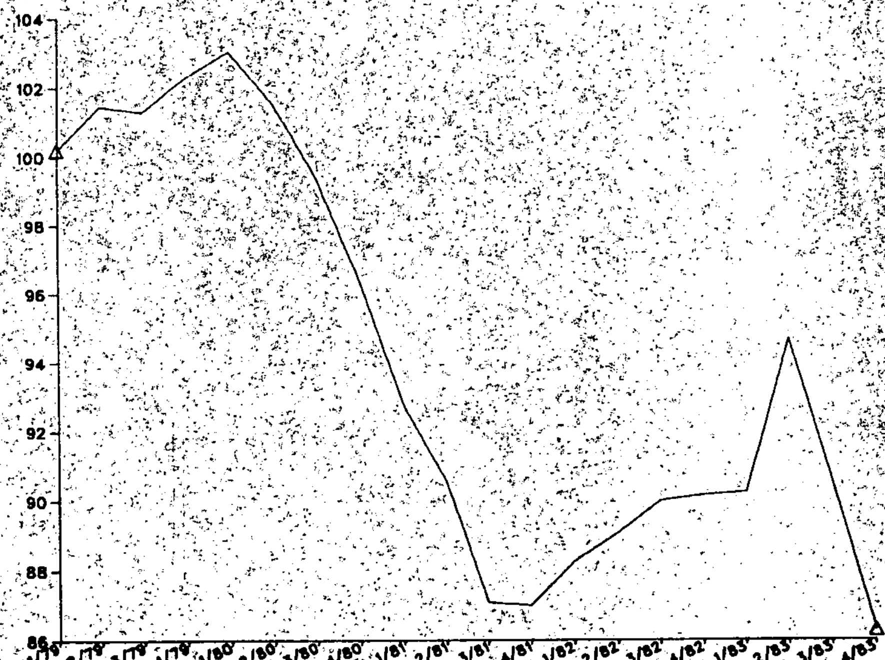
Figure 4
Australia: International Competitiveness (*)

1980=100



(*) This index measures the price competitiveness of Australian firms compared to its primary trading partners. It takes into account both differing rates of inflation and movements in exchange rates. An index number of 90, for example, could occur if Australian prices rose 11 percent more than prices in its trading partners or from an 11 percent appreciation of the Australian dollar.

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Original
- 1--OEA/ITM
- 1--OEA/SEAD
- 3--D/OEA
- 2--C/Production/OEA
- 1--[redacted] 25X1
- 1--C/NIC (7E62)
- 1--NIO/EA (7E62)
- 2--DDI (7E44)
- 5--CPAS/IMD/CB (7G07)
- 1--C/PES/DDI (7F24)
- 1--[redacted] 25X1

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